Consumers and Markets Group

Economic regulation of Heathrow Airport Limited: response to its request for a covid-19 related RAB adjustment – Appendices

CAP 1966A

Published by the Civil Aviation Authority, 2020

Civil Aviation Authority,
Aviation House,
Beehive Ring Road,
Crawley,
West Sussex,
RH6 0YR.

First published October 2020

Enquiries regarding the content of this publication should be addressed to: stewart.carter@caa.co.uk

The latest version of this document is available in electronic format at www.caa.co.uk

Contents

Appendix A

Our duties

A1 The CAA is an independent economic regulator. Our duties in relation to the economic regulation of airport operation services ("AOS"), including capacity expansion, are set out in the CAA12.

A2 CAA12 gives the CAA a general ("primary") duty, to carry out its functions under CAA12 in a manner which it considers will further the interests of users of air transport services regarding the range, availability, continuity, cost and quality of AOS.

A3 CAA12 defines users of air transport services as present and future passengers and those with a right in property carried by the service (i.e. cargo owners). We often refer to these users by using the shorthand of "consumers".

A4 The CAA must also carry out its functions, where appropriate, in a manner that will promote competition in the provision of AOS.

A5 In discharging this primary duty, the CAA must also have regard to a range of other matters specified in the CAA12. These include:

- the need to secure that each licensee is able to finance its licensed activities;
- the need to secure that all reasonable demands for AOS are met;
- the need to promote economy and efficiency on the part of licensees in the provision of AOS;
- the need to secure that the licensee is able to take reasonable measures to reduce, control and/or mitigate adverse environmental effects;
- any guidance issued by the Secretary of State or international obligation on the UK notified by the Secretary of State; and
- the Better Regulation principles.

A6 In relation to the capacity expansion at Heathrow, these duties relate to the CAA’s functions concerning the activities of HAL as the operator at Heathrow.

A7 CAA12 also sets out the circumstances in which we can regulate airport operators through an economic licence. In particular, airport operators must be subject to economic regulation where they fulfil the Market Power Test as set out in CAA12. Airport operators that do not fulfil the Test are not subject to economic regulation. As a result of the market power determinations we completed in 2014 both HAL and GAL are subject to economic regulation.

A8 We are only required to update these determinations if we are requested to do so and there has been a material change in circumstances since the most recent determination. We may also undertake a market power determination whenever we consider it appropriate to do so.

Appendix B

Glossary

Acronym/term	Definition
ADP	Airport operator Groupe ADP, formerly Aéroports de Paris, based in Paris.
ADR	Airport operator ADR Group or Aeroporti di Roma, based in Rome.
Aena	Airport operator Aena SME, based in Spain.
AOC	Airline Operators’ Committee (for Heathrow), a private company limited by guarantee.
AOS	Airport operation services, as defined in section 68 CAA12.
BA/IAG	British Airways plc/International Airlines Group (owner of British Airways).
Beta	A measure of the perceived riskiness of an investment relative to the equity market as a whole. Entities with a beta of less than one are considered less risky than the market as a whole, while a beta greater than one indicates that the investment is considered more risky than the market as a whole.
CAA (“us”/”we”)	The Civil Aviation Authority.
CAA12	Civil Aviation Act 2012.
Capex	Capital expenditure.
CMA	The Competition and Markets Authority.
Commercial deal or Commercial Agreement	The Agreement entered into between HAL and airlines that applies in 2020 and 2021 and provides for: • a “fixed rebate” to all airlines currently operating from Heathrow totalling £260 million, split into two equal payments of £130 million for 2020 and 2021; • a further volume rebate if the number of passengers rises above certain thresholds in 2020 and 2021;

Acronym/term	Definition
	• if passenger numbers were to turn out significantly lower than expected, the commercial deal also provides for some downside protection for HAL (in these circumstances the fixed rebate to airlines would be reduced); and • default arrangements for any airlines that did not sign the commercial deal, so that those "non-signatory" airlines would receive an appropriate share of the fixed rebate but would not benefit from the volume rebate. Further details and discussion of the commercial deal are set out in CAP1852, "Economic regulation of Heathrow Airport Limited from January 2020: notice of licence modifications". See www.caa.co.uk/CAP1852.
Commercial revenues	Revenues HAL derives from services to passengers, such as retail, food and beverage, *bureaux de change*, advertising, car parking and car rental, or from services to airlines, check-in desks, office rental, airline lounges and warehousing.
Constructive engagement	The process for engagement between HAL and its airlines customers as part of the H7 price control process.
Consumers	As defined in CAA12, consumers are passengers and cargo owners, both now and in the future.
Delayed recovery	HAL's scenario in its request with relatively rapid recovery in traffic.
Deprecation holiday	A period over which regulatory depreciation is included in aeronautical charges but not removed from the RAB.
ERA	Economic regulation agreement, for ADP.
ex ante	Based on forecasts/before an event.
ex post	Based on actuals/after the event.
Financing platform	The "whole business securitisation" funding arrangements used by HAL to raise debt finance. Details of the arrangements comprising HAL's financing platform can be found at: https://www.heathrow.com/company/investor-centre/offering_related-documents.
Gearing	Ratio of a regulated company's debt to its RAB.

Acronym/term	Definition
H7	The next HAL price control that we assume will be in place from 1 January 2022. If set for the usual five year period, this will run for the years 2022 to 2026.
H8	The next HAL price control period after H7. If H7 is set for the usual five year period, H8 will start from the year 2027.
HAL	Heathrow Airport Limited, the licence holder and operator of Heathrow airport.
Heathrow Finance Plc	A holding company of HAL, which owns and operates Heathrow airport.
IBP	HAL's "Initial Business Plan" for the expansion of Heathrow Airport. The IBP was provided to the CAA in December 2019 and was prepared in the expectation of a 3rd runway being built.
IDoK	Interim determination of the K factor, a regulatory tool used in the UK water sector.
iH7	Interim H7 price control. Runs from 1 January 2020 until 31 December 2021.
LACC	London (Heathrow) Airline Consultative Committee, set up by IATA to implement a collaborative consultation framework for Heathrow airport.
NERL	NATS En Route plc.
Opex	Operational expenditure.
ORCs	Other Regulated Charges.
PCM	Price Control Model.
Q4 or Q4 price control	The "Q4" price control was the price control for the period from 2003 to 2008. See for example CAA decision document covering Q5 price control here.
Q5 or Q5 price control	The "Q5" price control is the price control for the period from 2008 to 2014. See for example CAA decision document covering Q5 price control here.
Q6 or Q6 price control	The "Q6" price control is the price control for the period from April 2014 to end of December 2018, the approach to which

Acronym/term	Definition
	has subsequently been successively extended to cover 2019-2021. For the Q6 final decision, see www.caa.co.uk/cap1138.
QoS	HAL's quality of service, which is regulated through the SQRB scheme in its licence granted under CAA12.
RAB	Regulatory Asset Base.
Spread (also "bond spread")	The difference between the yield on a corporate bond and the yield on a risk-free security such as a government bond.
SQRB	Service quality rebates and bonuses, a scheme of incentives within HAL's current price control in its licence granted under CAA12.
Star Alliance	An airline alliance with 26 member airlines.
TRS	Traffic risk sharing mechanism.
United	United Airlines.
VAA/Virgin	Virgin Atlantic Airways.
WACC	Weighted Average Cost of Capital.
WTP	Willingness to pay survey.

Appendix C

Quality of Service and Investment Issues

Introduction

C.1 In its request for a RAB adjustment, HAL highlighted a number of actions taken within its business to limit its monthly cash outflow.

C.2 However, despite these measures, HAL stated that, without regulatory intervention, further actions would be needed to reduce costs and investment so that it can maintain acceptable liquidity. HAL suggested that these actions could be expected to have a detrimental impact on the quality of service ("QoS") received by consumers, as well as an impact on its ability to invest in Heathrow airport.

C.3 In this Appendix, we summarise the parts of HAL's request that relate to QoS and investment issues, and provide our initial assessment of the evidence that HAL has provided.

Summary of HAL's request

C.4 In its request, HAL stated that it has *"mitigated the impact to the extent possible"* of the large drop in passenger numbers, *"to protect the business and conserve cash"*, by undertaking *"decisive actions"*.

C.5 HAL provided the following examples of actions it has undertaken to save cash totalling around £80 million per month:

- consolidating operations onto one runway and temporarily closing terminals 3 and 4 and areas of Terminals 2 and 5;
- cutting its capex programme for 2020 from £1.9 billion to £445 million (over £250 million of which had already been spent when the impact of covid-19 pandemic started to be felt);
- implementing temporary pay reductions of between 10 and 25% for all colleagues;

- undertaking a company-wide reorganisation, making over 500 head office staff and 880 front line staff redundant to date; and
- furloughing over 50% of its staff.

C.6 However, despite these measures, HAL stated that without regulatory intervention, it will have to take further steps to reduce costs and investment so that acceptable liquidity can be maintained. HAL also indicated its view that these cost reductions would be likely to be asymmetric, in that it will not be able to reverse them quickly as demand at the airport recovers, and that this will potentially impair QoS in those circumstances.

C.7 HAL provided the following list of potential actions relating to QoS and investment:

- **Further permanent headcount reductions:** HAL stated that this would be likely to have a significant impact on QoS and costs as the airport returns to more normal operations. It stated that it might need to constrain passenger throughput in future or that the re-hiring of staff to meet demand increases would result in additional costs and delay. HAL suggested that service standards would fall for an extended period and provided examples of longer queuing times and reduced on time departures to illustrate this point.[1]

  HAL noted that the same dynamic would be seen in most, if not all, of HAL's costs, such as maintenance, customer service, access, resilience and information, with similar long term asymmetric effects. It also stated that regulatory intervention will enable it to avoid taking such cost reduction decisions and meet new covid-19 health related requirements more effectively, increasing consumer confidence in safe travel and helping to re-establish its route network.

- **Investment will continue to be drastically curtailed including into H7:** HAL stated that investment can currently only be made on safety

[1] HAL attempted to quantify the impact of these QoS reductions using the illustrative examples of on time departures falling from 80% to 60% (the recent levels at Gatwick) and a 5 minute increase in security queue time. It calculated this would result in a loss of consumer welfare of £570 million and £150 million respectively. This calculation utilised the results of their Willingness to Pay ("WTP") Survey set out in HAL's IBP.

critical items and to complete works already underway where pausing work would be extremely uneconomical. It expected this to result in a backlog of maintenance capex needed in future years which could be detrimental to future service if it could not be funded.

Further, HAL suggested that the current lower utilisation of the airport provided an opportunity for it to undertake capital maintenance projects more efficiently and effectively, for example, because it would not be required to undertake work in short windows during the night. HAL stated that a RAB based recovery mechanism would allow greater investment during 2021.

- **HAL will not be able to provide its partners with the support they need to help with their recovery:** HAL stated that the recovery of the airport will depend on a large number of partners at the airport, including the airlines, retailers, ground handlers and others. It also stated that an appropriate recovery mechanism would place it in a better position to be able to help these partners with their recovery and ensure consumers receive the service experience they desire throughout their airport journey.

Our initial assessment

C.8 We recognise that HAL has seen a very significant fall in its revenues as a result of the impact of the covid-19 pandemic and that there is uncertainty about the recovery in passenger traffic. If the recovery is relatively slow, this could put significant strain on HAL's financeability and its ability to invest.

C.9 HAL has set out a number of actions which it considers it would need to undertake in the absence of a RAB based adjustment in order to preserve cash. While we agree these actions would be likely to drive some detrimental impact on the services that consumers receive, we have a number of concerns with the quality of the supporting analysis and evidence provided by HAL in support of its request. These concerns are principally that:

- the issues that HAL has raised about reduced quality of service and levels of investment seem to be primarily caused by issues around a lack of available liquidity and HAL's financial position. As we set out in Appendix D, our initial assessment is that we are not persuaded on the basis of the evidence HAL has provided that the financial issues HAL identifies justify the need for immediate intervention, nor that it is for consumers to resolve these financial issues when they have been exacerbated by HAL's chosen high level of gearing;

- HAL does not appear to have considered the functions of the existing regulatory framework in providing appropriate incentives for HAL to maintain an appropriate quality of service (through the SQRB scheme which means that HAL faces penalties for reduced quality of service) and to support increases in passenger volumes (which is incentivised through the additional revenue that HAL will receive). We would need robust justification that short term regulatory intervention is appropriate, as there are existing arrangements for incentivising HAL's service quality. Furthermore, a significant short term reduction in investment may be an appropriate reaction to the present level of passenger traffic and uncertainty. We note that all companies across the aviation sector are reducing their investment and that HAL is starting from a base where it has provided high levels of investment and levels of service in recent years;
- HAL has not provided supporting evidence that quantifies either the short or long term detrimental impact on the consumer of the actions it suggests it would take without the RAB adjustment. This evidence is needed to link the requested RAB adjustment to the actions that HAL will take and the resulting benefits that consumers will receive, and so demonstrate how the RAB adjustment furthers the interest of consumers; and
- HAL has not considered whether there are other options for regulatory intervention that could be demonstrated to be targeted and proportionate in mitigating some of the specific QoS and investment issues it has highlighted.

C.10 In addition to the broader concerns identified above, we have a more specific concern over the HAL's use of its "willingness to pay" ("WTP") survey, which was commissioned for its IBP, to calculate the illustrative costs to the consumer of a deterioration in QoS. HAL estimated that, if on time departures fell from 80% to

60%, and security queueing times increased by 5 minutes, this would lead to combined consumer welfare losses of £720 million per annum. We have concerns over:

- the interpretation of the WTP research and the weight placed on this, given the importance that consumers place on value for money and affordability;
- placing weight on WTP survey results conducted in the context of expansion and without considering how the change in circumstances arising due to the impact of the covid-19 pandemic may be expected to lead to different WTP outcomes; and
- HAL's use of a reduced level of service at Gatwick airport to illustrate its point rather than attempting to estimate what the impact would be at Heathrow.

C.11 Further, we need to consider the possibility that the some of the actions HAL has said it is seeking to avoid in terms of cost reduction may be appropriate given emerging evidence on more protracted recovery in passenger numbers.[2]

C.12 We also note the RAB adjustment that HAL has requested seeks to recover much of the shortfall in revenue HAL has experienced as a result of the impact of the covid-19 pandemic, but that the actions that HAL has already taken to mitigate that impact on its business include a significant reduction in costs. HAL has not adequately justified the approach of seeking that customers pay for the reduction in revenues while HAL retains the benefits of the associated reduction in its costs. Our initial assessment suggests such an approach is inconsistent and not in consumers' interests.

C.13 Bearing all of the above in mind, our initial conclusions are that there is insufficient evidence to support immediate regulatory intervention in terms of quality of service and investment and, even if such evidence were to emerge, HAL's RAB adjustment might not be a proportionate way of dealing with these difficulties.

C.14 While HAL has not made the case for immediate intervention, it has raised important issues that we should consider during the course of the H7 review,

---

2 We note that recent Eurocontrol traffic forecasts suggests a more protracted recovery in traffic levels.

including having arrangements in place to support the funding of an appropriate level of investment.

C.15 As noted in chapter 2 of this consultation, in reaching these initial views, we are very mindful that evidence of the financial impact of the covid-19 pandemic on the aviation sector continues to emerge. Therefore, we will continue to keep the short term position under review and consider any further information HAL or other stakeholders provide on these matters.

Appendix D

Financeability and Cost of Capital

Introduction

D.1 HAL's request discussed the impact of the covid-19 pandemic on its cost of capital, financial position and performance. It stated that regulatory action has an essential role in supporting HAL's ongoing financial stability.

D.2 In this Appendix, we summarise the parts of HAL's submission that relate to the cost of capital and HAL's ongoing financial stability and provide our initial assessment of the arguments that HAL has put forward.

Summary of HAL's request

D.3 HAL's request detailed the impact of the covid-19 pandemic on its business. In doing so, it described a number of impacts on its financial position, performance and outlook. These include:

i) an ongoing negative monthly cashflow of £159 million per month (reduced from £240 million per month as a result of cost saving actions);

ii) a severe curtailment of the capital expenditure program for 2020 and 2021 and noting that HAL's ability to invest in the H7 period will also be "significantly curtailed";

iii) a statement that, in the long-term, HAL "is being re-graded as a riskier business" and this "poses very serious questions of financeability and affordability for consumers";

iv) an assessment that "trigger events" under HAL's financing platform will occur with the consequence that HAL will be unable to pay dividends; and

v) an assessment that Heathrow Finance Plc will breach key covenant ratios in 2020 (for which it has already obtained waivers from creditors).

D.4 HAL noted that these difficulties will put strain on its financing and create upward pressure on its cost of capital, which would feed through to higher airport charges. HAL also noted that the current situation challenges the RAB model of regulation, claiming *that "the RAB has no value because we cannot earn on it" and* that ongoing regulatory depreciation without commensurate revenue results in a permanent loss of value.

D.5 HAL assessed its future financing needs and options, noting that it will need to raise additional finance in 2021. HAL stated that in the event traffic was worse than forecast, a RAB adjustment would be necessary to facilitate the raising of this finance, since additional debt would otherwise put HAL in breach of its covenants and new cash equity contributions would be uneconomic given the prospective level of returns compared to its cost of capital.

D.6 It stated that "urgent" support is necessary to support both good levels of customer service and investment and to avoid long term increases in HAL's cost of capital. HAL also suggested that a RAB adjustment would be consistent with the CAA's statutory duties,[3] including the duty on the CAA to have regard to the ability for HAL to be able to finance its activities at Heathrow airport. HAL also specifically stated that, if a decision on the RAB adjustment were only taken as part of the H7 final determination, this would be *"inconsistent with the CAA's financeability duty."*

D.7 In describing the impact of the covid-19 pandemic on its cost of capital, HAL submitted evidence of the spread on its bonds and highlighted the fact that HAL's bond spreads have increased more than the average of an index of comparator bonds.[4] HAL identified an increase in Heathrow's cost of debt, relative to other businesses, of 0.7%.

D.8 HAL noted that its debt has been downgraded by credit rating agencies.[5] HAL's request identified one of the benefits of the RAB adjustment as being that it would

---

3 Under section 1 of the Civil Aviation Act 2012, see Appendix A for further detail of the CAA's duties.

4 HAL refers to the iBoxx index of A rated bonds issued by non-financial corporate entities with 10 or more years to maturity. For reference, HAL's senior debt is currently rated A- by Fitch and BBB+ by Standard &Poors' (S&P).

5 S&P has reduced Heathrow's class A debt from A- to BBB+ and placed it on negative outlook (credit watch with negative implications). Fitch has kept HAL's class A debt at A- but placed it on a negative outlook.

reduce market perceptions of risk and help to restore Heathrow's A- credit rating. HAL also linked the restoration of an A- credit rating to the potential viability of airport expansion in the future.

D.9 It also provided evidence of the impact of the covid-19 pandemic on the cost of equity, producing a chart showing the equity beta of two comparator airports, namely ADP (owner of Charles de Gaulle airport) and Fraport (owner of Frankfurt airport). HAL compared the evidence from the recent observations of the beta for ADP and Fraport with the beta in previous regulatory submissions and determinations as shown below:

Figure A.D.1: Estimates of airport asset beta (assuming debt beta of 0.05)

	CAA Q6	**Heathrow Q6**	**CMA NERL**	**Current airport beta**
Asset beta	0.471[6]	0.55-0.60	0.515-0.615	0.8-0.9

Source: HAL's RAB adjustment request

D.10 HAL linked the current high cost of equity to shareholders' considerations when contemplating investing new equity to support HAL. HAL stated that *"it is currently not rational for equity investors to invest more money to fund greater expenditure"* as the incremental cash flow for investors would be negative. HAL went on to state that the CAA has a *"duty to ensure that Heathrow can finance its functions"*[7] and interpreted this to mean that the CAA must *"create a regulatory framework where it is rational for investors to provide more money when it is required in the best interests of consumers"*. We discuss these matters further below.

[6] CAA estimate of asset beta was 0.501 with a debt beta of 0.1 (CAP 1140). The equivalent asset beta for a debt beta of 0.05 at 60% gearing is 0.471

[7] We consider the requirement as set out in CAA12 is somewhat different to this wording. We discuss this in paragraph 12 below.

CAA's initial assessment

Financeability and the CAA's statutory duties

D.11 The CAA must act in accordance with its statutory duties.[8] Our primary duty requires the CAA to further the interests of consumers, which it must do, where appropriate, by promoting competition in the provision of AoS.

D.12 In discharging this primary duty, the CAA is required to "have regard to" a range of matters, one of which is "*the need to secure that each holder of a licence … is able to finance the provision of airport operation services in the area for which the licence is granted*."[9] We are clear that this duty does not require the CAA to secure HAL's ability to finance its activities at Heathrow airport. Rather, it requires us to consider the ability of HAL to finance those activities as part of its overall consideration of how to carry out its duties in the manner it considers will further the interests of consumers. As such, financeability is only one of several matters that the CAA must consider, and we disagree with HAL's specific interpretation of this duty as set out in its request.

D.13 HAL's submission raised the financeability duty several times, but provided limited evidence to support the claims it made about its financial position.[10] In particular, there was relatively little information on the decisions that HAL has previously taken to increase and maintain gearing significantly above the levels we have assumed in setting its price control, the lack of additional shareholder support for HAL, and the impact of these matters on its liquidity. At the same time, HAL cited difficulties with its liquidity as a primary driver of possible increases in its cost of capital and of the measures it is contemplating for further reductions in costs.

D.14 We review the evidence that HAL has provided on the cost of capital in the sections below.

8 See appendix A for further description of the CAA's statutory duties.

9 See section 1(3) CAA12.

10 Limited information on HAL's financial position and future financing requirements were presented in the appendices to the submission.

The cost of capital

D.15 HAL provided some evidence of the potential impact of the covid-19 pandemic on the cost of capital, although this analysis was incomplete. For example, it did not:

- look at all elements of the cost of capital; or
- attempt to estimate the incremental impact of the RAB adjustment on the cost of capital.

D.16 We also note that the covid-19 pandemic is an ongoing situation and the longer term impact on financial markets and the cost of capital for a regulated airport is, at present, both unknown and very difficult to forecast. Bearing this in mind, we intend to conduct a comprehensive analysis of the cost of capital as part of the H7 price determination process when we should have better information available. We will also be better able to make an in the round assessment of our decisions on HAL's regulatory framework and the impact of these decisions on its cost of capital.

D.17 This approach would also allow us to make consistent assumptions on financial structure and the cost of capital and promote a transparent and consistent approach to the development of the regulatory framework, which should help reduce perceptions of regulatory risk.

The impact of HAL's financial structure

D.18 The reduction in revenues that HAL has experienced is driven by the impact of the covid-19 pandemic, but, as noted above, HAL's resulting financial position is a product of both those revenues and its financial structure.

D.19 HAL's current, highly geared, financial structure is the result of choices made by HAL and its shareholders. At 31 December 2019, HAL's group level gearing[11] was 86.5%[12] and HAL expects that by 31 December 2020 this will have risen to 93.3%.

---

11 At the level of Heathrow Finance plc.

12 See page 15 of the June 2020 Heathrow investor report: https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/reports-and-presentations/investor-reports/Heathrow_SP_investor_report_June_2020.pdf

For Heathrow (SP) Limited, gearing was 74.8% at the 31 December 2019 and HAL expects that by 31 December 2020 this will have risen to 80.3%.[13] Both of these values are materially higher than the 60% gearing we assumed for the notional entity in conducting the Q6 price control determination. While the notional (60% geared) entity would still have faced a sharp reduction in its revenues as a result of the impact of the covid-19 pandemic, it would be likely to have had more financial flexibility to manage the associated cash flow difficulties as it would have a lower gearing.

D.20 HAL's submission discusses briefly the role of its existing shareholders in supporting financeability, but only to dismiss the possibility of further cash injections from them. HAL's claim that this would be uneconomic for shareholders to invest further is supported by only limited analysis and fails to address the key question as to why its customers should provide support for the business (through the RAB adjustment) when the financial difficulties appear, at least in part, to be exacerbated by the decisions of its management and shareholders.

Credit rating

D.21 We recognise that a RAB adjustment along the lines of HAL's request may be effective in reducing investors' perceptions of risk and may help HAL to achieve an A- credit rating. However, HAL has not provided evidence to demonstrate that achieving an A- credit rating would be appropriate and in consumers' interests. We note that HAL currently has negative cash flow and the future is highly uncertain. As a result, it is far from clear that supporting an A- credit rating would be an appropriate regulatory aim in the current circumstances, although we recognise that, to support future investment, there will continue to be advantages in HAL being able to access investment grade financing.[14]

---

[13] See page 15 of the June 2020 Heathrow investor report: https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/reports-and-presentations/investor-reports/Heathrow_SP_investor_report_June_2020.pdf

[14] In CAP 1876 (January 2020), we stated that a credit rating materially lower than the existing A- rating for HAL's senior debt would not be compatible with efficient financing. However, this was in the context of capacity expansion and as we have explained in CAP 1914 we are currently focusing on regulation of the airport without capacity expansion.

The case for immediate intervention

D.22 While HAL's submission stated that immediate regulatory intervention is required, we do not consider that a robust case for urgent intervention has been made in terms of HAL's financeability. The public statements in Heathrow's June 2020 investor report[15] and Ferrovial's first half 2020 results,[16] presented a positive view of HAL's finances. The investor report noted that *"Heathrow remains highly liquid"* and stated that the group had £3.0 billion of cash and committed facilities as at 30th April 2020. The investor report notes that the available liquidity is sufficient to *"meet all our obligations"* until *"well into 2022 under our forecast traffic scenarios."* The Ferrovial results report made similarly confident statements about Heathrow's liquidity.

D.23 Notwithstanding these statements, we recognise that, with traffic volumes as much reduced as they are, it is possible that HAL may experience financial difficulty earlier than 2022 if traffic volumes are lower than HAL forecast when preparing its June 2020 investor report.[17] We are, therefore, conducting further analysis to consider the possibility, likelihood and implications for consumers of possible financial difficulty. Until this work is complete, it would be premature to conclude that HAL faces an immediate financing issue or that granting HAL's RAB adjustment request would be a proportionate response.

D.24 HAL can further support this work by providing a fully populated version of our price control model ("PCM") with assumptions and projections that would properly support the carrying out of meaningful financeability analysis.

The value of the RAB and depreciation

D.25 HAL's suggestions that, without being able to *"earn on it"*, the RAB *"has no value"* and that ongoing depreciation represents a permanent loss of value warrant further consideration. The current situation in which a RAB regulated business is

---

15 See https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/reports-and-presentations/investor-reports/Heathrow_SP_investor_report_June_2020.pdf

16 See https://static.ferrovial.com/wp-content/uploads/2020/07/30175403/1h2020-ferrovial-results-presentation.pdf

17 See https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/reports-and-presentations/investor-reports/Heathrow_SP_investor_report_June_2020.pdf

only able to recover revenues at levels that are significantly below regulatory depreciation creates new issues and difficulties and we are not aware of any direct precedents. In such a situation, ongoing regulatory depreciation does reduce the value of the RAB without a corresponding return of value to investors. We can see in principle that this situation was not intended or expected at the time of the Q6 price determination.

D.26 We will consider what is an appropriate treatment for regulatory depreciation as part of the H7 price control review and whether there is a robust justification for an adjustment to reflect the revenue losses due to the impact of the covid-19 pandemic. This will allow us to consider these issues in the round, including the views of airlines that HAL has benefitted from significant outperformance earlier in the Q6 period and that this should be taken into account in considering whether any adjustments relating to regulatory depreciation are appropriate.

Conclusion

D.27 In conclusion, we consider that HAL has raised important issues that we should consider during the course of the H7 review. However, we are not persuaded, on the basis of the evidence provided, that the financial issues HAL identified in its request justify the need for immediate intervention, nor that the specific regulatory intervention that HAL requested is an appropriately proportionate or targeted response.

D.28 We note that the evidence provided by HAL in its request has a range of shortcomings, with the following important pieces of evidence missing or only partially provided:

- an assessment of a range of options for bolstering its financial position, including options that involve an element of new cash contributions from shareholders;
- robust cash flow modelling, ideally using the CAA's price control model, to demonstrate the expected evolution of the financial position of the notional entity as well as HAL's actual financial position;

- evidence of the case for immediate regulatory intervention and a reconciliation of this case to the public statements referred to above about HAL's financial position and liquidity;
- further analysis of the cost of capital that is more complete and considers all relevant factors, including those which may lead to a lower estimate;
- evidence on, and estimates for, the incremental impact on the cost of capital of different regulatory intervention options; and
- an assessment of the "pros and cons" of different levels of credit ratings to understand the net impact on consumers of achieving one credit rating level over another.

D.29 We will continue to assess the cost of capital and regulatory depreciation policy as part of the H7 process and to analyse the potential future financial position of HAL and the notional entity. We would welcome further engagement from HAL and other stakeholders in support of this analysis.

D.30 In reaching these initial views, we are very mindful that evidence of the financial impact of the covid-19 pandemic on the aviation sector continues to emerge. Therefore, we may revisit our position on these matters in the coming months depending on both the responses to this consultation and how the impact of the covid-19 pandemic on aviation sector, and HAL in particular, develops.

Appendix E

Historical Performance

Introduction

E.1 HAL's request set out its historical financial performance from 2003 to 2019 and its forecast financial performance from 2020 to 2021.

E.2 This appendix summarises the evidence provided by HAL and comments provided by airlines, and provides our initial assessment.

Summary of HAL's request

E.3 HAL stated that the overall returns achieved since 2003 have been significantly below the allowed returns set by the CAA. Its view is that the pre-tax return on RAB has been below the level targeted by the CAA despite strong performance at the end of Q6, and that the impact of the covid-19 pandemic in 2020 and 2021 has increased the size of this shortfall in returns.

Figure E1 Pre-tax return on the RAB, 2003 to 2021

Source: HAL's request

E.4 HAL also stated that the achieved dividend yield since 2003 has been lower than regulatory assumptions, as set out in Table E1.

Table E1 HAL's view of historical dividend yields

Dividend yield	Q4	Q5	Q6 & iH7
Target	7.00%	7.30%	6.80%
Achieved	0.00%	-2.38%	5.33%

Source: HAL's request

E.5 HAL noted that a shock allowance of 1.37% was subtracted from the base traffic forecast in each year of the Q6 price control settlement to take account of the average historical impact of asymmetrical shocks to Heathrow's passenger numbers (such as those that arose from the Eyjafjallajökull volcanic ash cloud in 2010 and 2008 financial crisis).

Airline views

E.6 Airlines have estimated that HAL's return on the RAB amounted to £840 million over Q6 and the Q6 extension period (2014-2019). This estimate is based on information in HAL's regulatory accounts and reflects the overall regulatory operating profit and out performance from the regulatory building blocks (passenger traffic, commercial revenues and opex).

E.7 The airlines' results are not directly comparable with the estimates provided by HAL given differences in the measures of returns and the focus of the airlines on the most recent regulatory period.

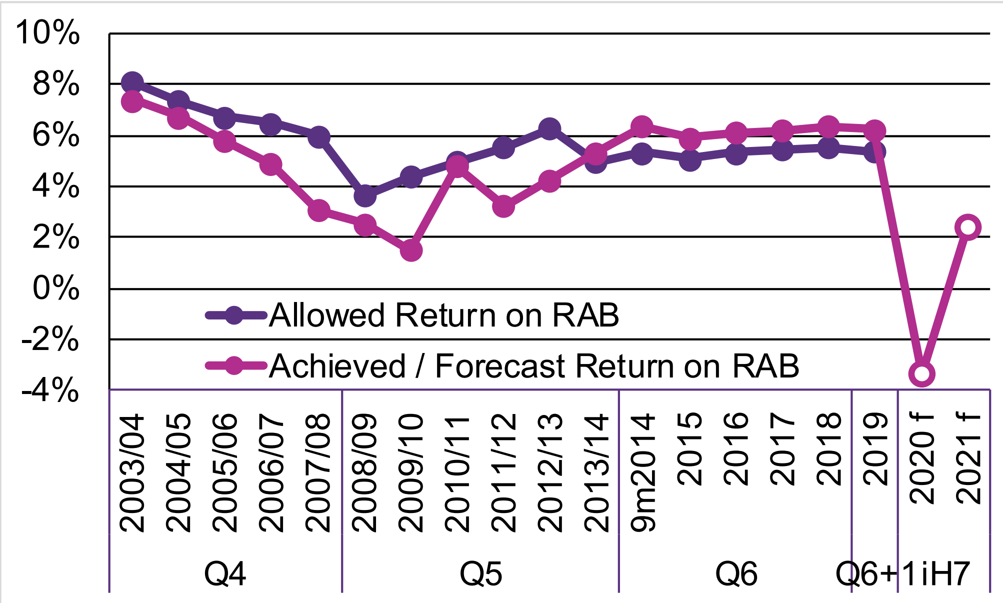
Our initial assessment

E.8 In its request, HAL has aggregated estimates for the pre-tax return from 2003 to 2019 and then from 2003 to 2021. In Figure E2, we present these estimates on an annual basis. This shows that, while HAL's achieved return was lower than the allowed return during Q4 and most of Q5, its achieved returns were higher than allowed returns from the end of Q5 (2013-14) through Q6 and the extension in

2019.[18] For the iH7 period, current forecasts show that HAL's achieved returns are forecast to be significantly lower.[19]

E.9 While HAL's evidence shows that it has tended to underperform the assumptions made in setting its price controls before 2010, we do not see that this historical period is as relevant as the Q6 period because the regulatory framework does not seek to guarantee shareholder returns. We also have concerns that HAL appears to be suggesting it should both keep out performance earned during Q6 and the 2019 extension and be compensated for the impact of the covid-19 pandemic during the two years of the commercial deal. This does not appear to be a balanced or proportionate approach.

Figure E2 Annual pre-tax return on the RAB, 2003/04 to 2021



Source: CAA analysis of HAL's request
Note: Forecast returns for 2020 and 2021

E.10 We have also sought properly to quantify and examine the main factors driving HAL's outperformance during Q6 and the 2019 extension by looking at the underlying price control building blocks. Our initial assessment of the estimated

---

18 We note some caution is needed in interpreting achieved returns in 2019.

19 We note that caution is needed in comparing achieved and allowed returns in the iH7 period (2020 and 2021) as the price control was based on a commercial deal between HAL and airlines rather than set using the CAA's regulatory building blocks.

net outperformance over this period is around £1,133 million (2018 prices) as shown in Table E2.[20] We have estimated the main sources of outperformance were aeronautical and single till revenues (driven by passenger volumes) and tax.[21] We note that these are initial estimates and may be subject to change with further analysis.

E.11 We note that airlines estimated HAL's outperformance to be £840 million over this period. The main difference between this and our estimates above appears to be that airlines did not include outperformance on the cost of debt and tax in their estimate. We note there are also some other smaller differences.[22]

E.12 We have also considered the passenger demand shock adjustment that was included as part of the Q6 price control settlement. For passenger volumes, in the Q6 determination, our passenger forecast included a reduction of 1.2% applied to reflect the average impact of historical shocks. We estimate that this adjustment gave a benefit to HAL of around £99 million in 2014 to 2018, which represented around 23% of the estimated total outperformance in airport charges of £432 million from 2014 to 2018 shown in Table E2.

Table E2 Our initial assessment of HAL's financial performance in Q6

Source	**Out- (+ve) / under- (-ve) performance (£m, 2018p)**
Q6 (2014-2018) **total outperformance**	862
Q6 extension (2019) **total outperformance**	250
Q6 and Q6 extension (2014-2019) total outperformance	**1,113**

20 We used historical RPI figures from the Office for National Statistics to convert all figures to 2018 prices.

21 For 2019, we needed to make assumptions for the individual building blocks given the price control was rolled forwards and not set based on underlying building blocks. For these estimates, we have assumed a 1% increase in both passenger volume and single till revenues and a reduction in opex of 1.5%.

22 The airlines aggregated outperformance across years and did not use the same base year of prices that we used (2018) and the airlines used an annualised return in 2014 without an adjustment to recognise that only 9 months of operations in 2014 occurred in the Q6 period. Correcting for these, we estimate that the measure of HAL's out-performance reduces from £840 million to £781 million (in 2018 prices). The remaining difference appears to be a difference in approach to estimating HAL's outperformance from passenger volumes.

Q6	Apr 2014 – Dec 2018				
Source	**Building block**	**Q6 outturn £m, 2018p**	**Q6 determination £m, 2018p**	**Out- (+ve) / under- (-ve) performance**	
				%	**£m, 2018p**
Based on regulatory accounts	Airport charges	8,583	8,151	5.3%	432
	Single till revenues	5,533	5,304	4.3%	229
	Opex	5,740	5,605	-2.4%	-135
Total building blocks					**526**
Based on Q6 WACC and annual accounts	Cost of debt	1,363	1,402	2.8%	39
	Tax	234	531	55.9%	297
Total cost of debt and tax					**336**
Total building blocks + cost of debt and tax					**862**

Q6 extension	Jan 2019 – Dec 2019				
Source	**Building block**	**Q6 outturn £m, 2018p**	**Q6 determination £m, 2018p**	**Out- (+ve) / under- (-ve) performance**	
				%	**£m, 2018p**
Based on regulatory accounts	Airport charges	1,807	1,673	8.0%	134
	Single till revenues	1,189	1,132	5.0%	57
	Opex	1,126	1,088	-3.5%	-38
Total building blocks					**152**
Based on Q6 WACC and annual accounts	Cost of debt	210	293	28.3%	83
	Tax	96	111	13.7%	15
Total cost of debt and tax					**98**
Total building blocks + cost of debt and tax					**250**

Source: CAA analysis of HAL regulatory accounts and Heathrow (SP) Limited annual accounts

Note 1: For the cost of debt and tax, the regulatory assumptions are taken from the allowed return. We recognise the outturn varies significantly from one year to the next as it can be influenced by factors such as complex derivative operations and tax calculations. For this initial assessment of the tax calculation, we have used the cash flow statements in the annual accounts.

Appendix F

Regulatory Precedent and Case Studies

Introduction

F.1 HAL's request referred to a number of examples of traffic risk sharing ("TRS") mechanisms in the regulatory frameworks for other European airports as well as the arrangements applying to NERL. It also discussed examples of uncertainty mechanisms used in other UK regulated sectors.

F.2 In this appendix, we present our assessment of these examples, as well as considering other precedents and case studies that we consider are relevant to consideration of HAL's request. We start with the summary of HAL's request and responses from airlines and then present our initial assessment of these matters.

Summary of HAL's request

European airports and NERL

F.3 HAL stated that a range of European airports have mechanisms in place to deal with the impact of exceptional circumstances. It summarised these in the way shown in Table F1 below and noted that:

- none of the comparator airports bear more than one year's impact of an exceptional event;
- others have specific limits to the amount of risk they are expected to bear, set at 10% of revenue or lower. For example, HAL noted that ADR and Aena have the ability to recover losses of over 6% and 10% respectively, while Schiphol has the ability to recover all lost revenue over the following three years; and
- all of these airports, apart from Schiphol, were likely to examine options with their regulators that would allow recovery to be spread over a longer period of time to mitigate the immediate impact on charges.

Table F1: HAL's summary of risk sharing arrangements at selected airports

Airport	Adjustment mechanism
AENA	If traffic is 10% lower than forecast, losses beyond this can be recovered through charges in the following year (n+2).
ADP	ADP has a traffic sharing mechanism for small deviations in passenger numbers and the ability to reopen its regulatory arrangements in the event of large deviations. ADP has applied for its charges to be redetermined due to exceptional circumstances.
Dublin Airport	A reopener mechanism within the Aviation Act allows for reopening of price control where there are substantial grounds for doing so.
Fraport	Can reset prices at any time for the following year.
ADR	If traffic is more than 6% different from forecast, then a tariff balancing mechanism is implemented for the remainder of period.
Schiphol Airport	Charges for the next year can be reset to reflect over/under recovery spread over three years.

Source: HAL's request

F.4 HAL also referred to the TRS arrangements for NERL's *en route* and London approach services, where, for traffic variations, NERL bears a risk up to 4.4% of its regulated revenues.

Other UK regulated sectors

F.5 HAL described examples of price controls being reopened in other regulated sectors in the UK. In particular, HAL noted that:

- water companies have mechanisms ("interim determinations (IDoKs)" and "substantial effects" clauses) that permit them to apply for within-period adjustments.[23] These have associated triggers where there are unexpected changes to relevant revenues or costs of 10% and 20% respectively;

[23] https://www.ofwat.gov.uk/regulated-companies/price-review/interim-determinations/ and https://www.ofwat.gov.uk/regulated-companies/price-review/substantial-effect-determinations/

- existing (and previous) energy network price controls contain mechanisms to manage uncertainty such as reopeners and mid-period reviews for specified items. Licences covering these regulated companies also include a condition relating to the disapplication of the price control in cases of financial distress;[24] and
- reopener mechanisms applied for regulation of rail for a material change in the circumstances of Network Rail or relevant financial markets, or if its expenditure in Scotland is forecast to be more than 15% higher than the determination over a three-year period.[25]

Airline views

F.6 The AOC/LACC wrote to the CAA[26] to express concerns about Heathrow's proposals. AOC/LACC noted that HAL's request explained some features of TRS arrangements at European airports, but it had not fully captured important details. AOC/LACC's view was that some airports' exposure would not be limited to revenue losses of only one year as HAL had suggested. AOC/LACC further noted that the circumstances under which airports can change airport charges to reflect exceptional circumstances are subject to certain restrictions.

Our initial assessment

F.7 In this section, we set out our initial assessment of relevant precedent from aviation and other UK regulated sectors, which includes some examples in addition to those raised by HAL.

Traffic risk sharing and uncertainty mechanisms in aviation

F.8 European airport regulation varies from price caps set *ex ante* by the regulator to annual/multi-year commercial agreements (subject to varying degrees of regulatory approval or oversight). Within longer term agreements or price caps,

---

24 https://www.ofgem.gov.uk/ofgem-publications/50666/guidance-doc-decision-doc-final.pdf

25 https://www.orr.gov.uk/monitoring-regulation/rail/networks/network-rail/price-controls/pr13/publications/final-determination-network-rails-outputs-and-funding-2014-19

26 Letter of 10 September 2020, from AOC/LACC to the CAA.

there are often TRS mechanisms[27] and the potential to reopen price controls in "exceptional circumstances."

F.9 From our review, it appears that the evidence on how airports and regulators are responding to the extreme impact of the covid-19 pandemic is mixed. It is also too soon to draw lessons on how these TRS mechanisms will account for the extreme impact of the covid-19 pandemic on traffic demand. In particular, we found that:

- so far, only ADP, which has traffic risk sharing under its Economic Regulation Agreement ("ERA"), has publicly indicated its request to terminate its long term agreement and revert to cost-related annual agreements. However, the termination of the ERA will not affect the current level of airport charges, which will be maintained until the end of FY 2021.[28] We note that, even if ADP moves to annual cost-based charges from 2021, French legislation requires price changes to be "moderate" and the French regulator rejected proposed increase in service charges at another airport.[29] This seems to support views from AOC/LACC that further restrictions in airports' price regulation and reopeners could still limit the scope of any price adjustments;
- Fraport and Zurich, which both operate under annual deals, have indicated they will not increase airport charges in 2020/21. Indeed, Zurich has offered a discount to apply to charges from 2021, which could continue until 2025 depending on the speed of the recovery from the impact of the covid-19 pandemic;[30]

[27] At many European airports, "hybrid" or "dual-till" arrangements mean that the TRS often applies only to aeronautical services rather than overall airport revenues that include commercial services.

[28] Page 17 of Amendment to Universal Registration document: https://www.parisaeroport.fr/docs/

[29] In July 2020, the French regulator rejected Nice Airport's proposed 12% increase in service charges (and a 14.2% increase in landing fees) to apply from November 2020. Even taking into account the impact of the covid-19 pandemic, the regulator did not consider the changes to be "moderate" as required by French legislation (Article L. 6327-2 of the French Transport Code, see pages 16-17 of www.autorite-transports.fr/wp-content/uploads/2020/06/decision-2020-032-version-publique.pdf)

[30] https://www.zurich-airport.com/the-company/media/news-center/2020/jul/ir-20200715-gebuerenverhandlung?cat=all&year=&search_string=

- the Irish regulator is consulting on Dublin airport's recent price control determination to see if it is necessary to make changes in light of the impact of the covid-19 pandemic, including the option of reopening the control. Although it has removed some existing price control targets on quality of service, it has yet to decide on further measures;
- at other airports, AENA (which is subject to a five year control) has deferred consultation on its charges until October 2020. We are yet to see proposals from Schiphol which, under certain circumstances, could propose changes to its current three year price agreement;[31] and
- for ANSPs, the European Commission has proposed to amend the traffic risk-sharing arrangements in the charging regulations, by revising cost targets in 2020 and 2021 to reflect efficient costs better and spread the recovery of revenue over a longer period to prevent significant rises in user charges in 2022.

The financial position of air transport companies and actions they have taken

F.10 From the H1 2020 interim results for a number of European airports, we have seen a 62% to 69% decline in passenger numbers compared with the same period in 2019, with most airports experiencing reductions in revenue of around 50%. This is broadly similar to HAL, which has seen a 60% fall in passenger numbers and a 51% fall in revenues.[32]

F.11 In response to lower traffic volumes, a number of other European airports have taken actions to reduce their operating expenditure ("opex") and defer planned capital investment. For example, AENA and Schiphol made opex savings of 15% compared with the same period in 2019, whereas other airports have achieved much higher opex savings (e.g. 21% for ADR, 23% for ADP, 28%[33] for Zurich and

31 https://www.schiphol.nl/en/download/b2b/1523624122/1T8kLVjBBmOiaKqOO4WC0K.pdf

32 Page 5, HAL H1 2020 financial results: https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/reports-and-presentations/financial-results/2020/Heathrow-(SP)-Limited-H1-2020-results-release.pdf

33 Zurich noted in its interim results that it incurred one-off costs in opex in 2019 and that adjusting for this its cost saving measures in H1 2020 were lower (-18%).

29% for Fraport). While HAL's opex savings appear to have been more modest (at 12% for H1),[34] caution is needed in drawing direct comparisons given the different circumstances in each country and at each airport, including different levels of capital investment and local government support.

F.12 Our review of financing actions by airports, airlines and other air transport companies has highlighted that many companies have taken significant and timely actions to seek to improve their financial positions by raising a combination of additional debt and equity, as well as from obtaining government support. We set out some key findings from our review below.

F.13 In Table F2 below, we summarise our understanding of some of the financial measures airports have taken to cover the cash flow impacts from a review of their H1 2020 results. In general, we found that airports, including HAL, have improved their financial positions by raising new debt and restricting dividends to shareholders. This has increased levels of gearing by one and three percentage points ("pp") for HAL's class A and class B debt respectively, which is slightly below the typical increases of five to ten percentage points observed at other airports. As for dividends, of the airports we reviewed, only ADP and HAL paid dividends to shareholders in H1 2020, although HAL does not plan further dividends in 2020.

Table F2: Financial results for selected airports H1 2020

Airport	Financing / investors	Estimated gearing as at 30 June 2020 compared to 31 Dec 2019
HAL	£100 million Q1 dividend payment approved in Feb 2020, no further payments planned in 2020. Additional new debt in H1 2020 totalling £130 million and drawing on £2,091 million of debt signed prior to the reporting period. Net nominal debt = £12,860 million (30 June 2020) vs £12,412 million (31 Dec 2020).	**Heathrow SP:** Class A- 68% vs 67% (+1pp) Class B- 78% vs 75% (+3pp). **Heathrow Finance:** 91% vs 87% (+4pp).

[34] For Q2 2020, HAL made a larger reduction of nearly 25%. Page 6, HAL H1 2020 financial results: https://www.heathrow.com/content/dam/heathrow/web/common/documents/company/investor/reports-and-presentations/financial-results/2020/Heathrow-(SP)-Limited-H1-2020-results-release.pdf

AENA	Zero dividends paid in 2020. New loans and increased availability of cash and credit facilities at 30 June 2020 to a total of €2,894 million. Gross financial debt now at €8,277 million from €6,349 million, although with cash injections net financial debt is broadly stable in H1 2020 relative to 2019.	52% vs 51% (+1 pp)
ADP (Paris)	€70 million dividend payment approved by shareholders in May 2020 - €0.70 per share (was projected to be €3.70).	56% vs 47% (+9 pp)
ADR (Rome)	Zero dividends paid in 2020. Increase in financial liabilities of €163 million and net financial debt increased to €1,289 million.	54% vs 46% (+8pp)
Fraport	Zero dividends proposed in 2020. Additional financing in H1 2020 of €1,275 million, gross debt increased to €6,334 million, increase in net financial debt of €618m to €4,147 million. Further bond issue in July of €793 million.	53% vs 47% (+6pp)
Schiphol Group	Zero dividends paid in 2020. €1.3 billion new borrowing. Total borrowing stands at €3,609 million as of 30 June 2020, vs. €2,772 million as of 31 December 2019.	47% vs 39% (+8pp)
Zurich	Zero dividends paid in 2020. CHF0.7bn new borrowing. Total borrowing stands at CHF2,035 million as at 30 June 2020, vs. CHF1,311 million as at 31 December 2019.	46% vs 36% (+10pp)

Source: CAA analysis of reported H1 2020 financial results (Dublin H1 2020 not yet available)

F.14 A number of companies with strong transport interests have sought to improve their financial position by raising new equity. For example, Sydney airport announced it was raising new equity of AUS$2 billion,[35] IAG has launched a rights issue of EUR 2.75 billion,[36] Ryanair is raising additional equity of around EUR 400 million,[37] and Rolls Royce is currently reviewing whether to issue new shares of up to £2.5 billion and is in talks with sovereign wealth funds.[38]

[35] https://assets.ctfassets.net/v228i5y5k0x4/7VqtkzjZornzWOIALdl1j/d884688a31e23aac0a68e0a2e49909c8/Notice_of_Equity_Raising_and_Half_Year_Results_Briefing.pdf

[36] https://www.iairgroup.com/~/media/Files/I/IAG/press-releases/english/2020/Fully%20Underwritten%20Capital%20Increase%20to%20Raise%20Gross%20Proceeds%20of%202741%20million.pdf

[37] https://www.insidermedia.com/news/national/ryanair-raising-400m-for-growth-opportunities

[38] https://otp.tools.investis.com/clients/uk/rolls_royce2/rns/regulatory-story.aspx?cid=171&newsid=1417432

F.15 Other examples of actions include companies that are looking to secure government loans (e.g. TAP which secured up to EUR 1.2 billion in loans);[39] carry out restructurings with debt for equity swaps (e.g. Swissport, where senior debt is converted to equity)[40] or sell parts of the business (e.g. Virgin Atlantic/Virgin Australia).[41]

Other regulated sectors in the UK

F.16 In other UK regulated sectors, such as water, energy and rail, uncertainty mechanisms such as price control reopeners exist to deal with exceptional and unforeseen events that are outside of the control of the regulated company. Our review has highlighted that regulators have taken into account their statutory duties to consumers and the circumstances in the round in considering applications for adjusting or reopening price controls, rather than this being a narrow or mechanical exercise. This supports an approach where any regulatory response should be proportionate and in line with our statutory duties.

F.17 For example, in the water sector, HAL noted the IDoK and substantial effects reopener clauses and the two successful "substantial adverse effect" requests in 2003 made by Northumbrian Water and Bournemouth & West Hampshire Water reflecting cases where volumes were materially lower than anticipated. However, we note that there have been other examples where Ofwat or the CMA did not accept that adjustments would be in the interest of consumers:

- **Thames Water's IDoK application**: Ofwat decided that the application did not meet the 10% materiality threshold required for an IDoK. In doing so, it took into account its duties through an "in the round" assessment of unforeseen changes that had been in Thames Water's favour as well as against it and the company's financial position; and

---

39 https://www.tapairportugal.com/en/-/media/Institucional/PDFs/Investidores/Comunicados/Comunicado_4Set20_EN.pdf?la=en&hash=88F191271A81AC79EEA98C02792D4F88A71117E5

40 https://www.flightglobal.com/air-transport/creditors-to-take-over-swissport-under-debt-for-equity-restructuring/139962.article

41 https://www.theguardian.com/business/2020/sep/04/virgin-australia-sale-to-bain-capital-passes-creditor-vote

- **Sutton and East Surrey Water (SES) substantial effects application**: on appeal to the Competition Commission (now the CMA), the Competition Commission determined that, while SES's application passed the materiality threshold, when balanced against Ofwat's duties such as consumers' interests, it would not be appropriate to make an adjustment. It considered that it was in consumers' short term interests to keep prices within the existing cap unless consumers would face higher prices in the medium to long term.[42]

F.18 We have also found that the energy and rail regulators would consider the merits of any reopener application taking into account their wider duties. [43, 44]

Railtrack case study

F.19 HAL's request set out a solution that would involve consumers bearing a significant proportion of the costs associated with the impact of the covid-19 pandemic and providing additional protection for shareholders. We have considered Railtrack (Network Rail's predecessor) as a relevant example of when a regulated company has faced severe financial issues, though we recognise there a number of important differences in circumstances, such as the causes of these issues and the extent of government intervention. As a result, we need to be cautious indrawing direct comparisons between the two situations.

F.20 For Railtrack, a series of investment overspends together with its response to a series of railway disasters, including the Hatfield crash, led to significant costs and payments to train operating companies. Railtrack's response to the financial difficulties was to seek additional funding from government to avoid shareholders losing equity. In 2001, the Secretary of State petitioned a High Court to put Railtrack into railway administration as it would be unable to pay its debts. He

42 https://assets.publishing.service.gov.uk/media/55194778ed915d14270000d7/549.pdf

43 https://www.ofgem.gov.uk/ofgem-publications/50666/guidance-doc-decision-doc-finalpdf

44 http://www.infrastructureintelligence.com/sites/default/files/article_uploads/ORR%20CP5%20Draft%20%20Determination.pdf

stated that tax payers and rail users were his primary consideration and his view was that shareholders should accept that their investments come with risks:

> *"The Government stands behind the rail system but not individual rail companies and their shareholders who need to be fully aware of the projected liabilities of the companies in which they invest and the performance risks they face".*[45]

[45] http://researchbriefings.files.parliament.uk/documents/SN01076/SN01076.pdf